DOW THEORY LETTERS INC.

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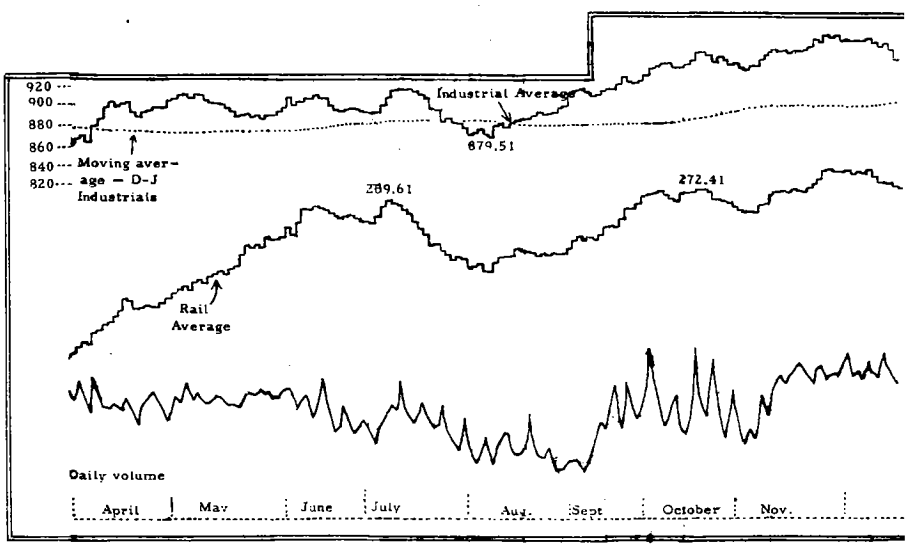
THE MARKET: Confusion has been steadily building up in the stock market and the economy over the last quarter. As the final week arrives, I would have to say that confusion has reached almost "total" proportions (see quote by Humphrey Neill under Notes & Quotes).

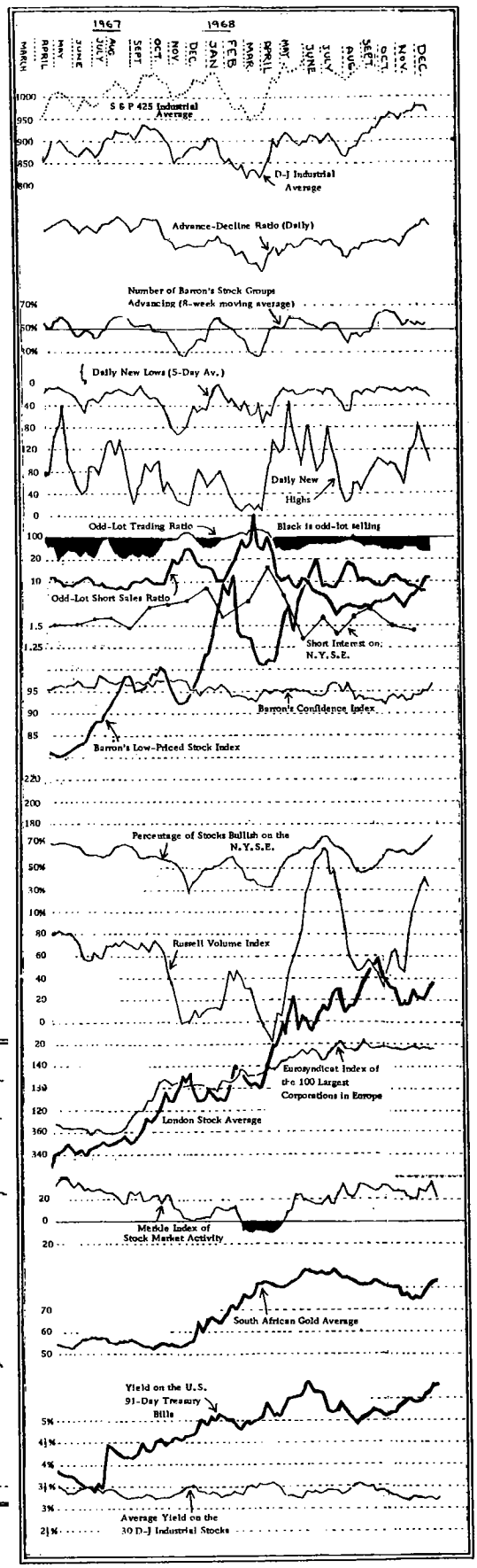
What has been happening during late-1968 almost boggles the mind of the poor analyst. Consider this: business is booming along with demands on the money market for capital expansion reaching towering proportions. A new Administration is about to enter, bringing with them (as Eliot Janeway puts it) a budget outlook for "an increase of major significance in military spending (at the request of the Nixon Administration; for a still greater increase in welfare spending (on the initiative and insistence of the Democratic Congress); and for an undeniable and eventually acceptable break-through in Federal Deficit spending."

In the face of this, interest rates are rushing through to all-time highs in all sectors of the money markets (see later section), thereby giving Wall Street the most severe yield competition in 100 years.

Speculation of all types has reached white-hot proportions. In London a Rembrandt sold last week for 35,000 pounds, the highest price ever paid for a drawing (not an oil painting). Speculative markets exist in wines, coins, stamps, furniture, English silver, antiques, almost every conceivable item. The distrust of money is accelerating a world-wide rush into "things."

During 1968 about 90 new mutual funds have been started, bringing the known total of mutual funds to an astounding figure of nearly 400. There are also about 60 closed-end funds, and the total of fund money invested in the market is probably around $60 billion. In truth, the funds now constitute a sort of public or crowd of their own. Can they all be right in 1969? Can their current high-volume turnover of transactions lead to general success? It is hard to believe.




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Euroyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

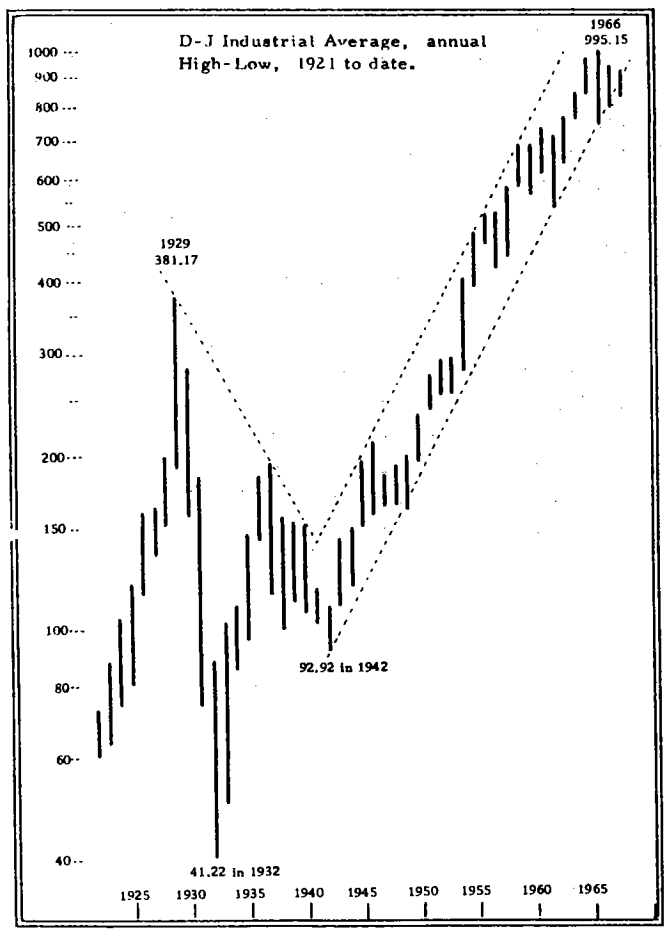
It seems to me that bullishness and broad enthusiasm regarding the market has somehow reached a peak at this time. Nothing is taken seriously, the interest rates, the gold problem, the monetary dislocations, the trade problems, or for that matter the sell off in the market which marked the week or so before Christmas. From all quarters I am told that 1000 on the Dow is simply a matter of time, perhaps the last week of 1968 or more probably it will occur during the early weeks of January. Wall Street is now the numbers game, and all tallies are supposed to total 1000.

Meanwhile, what is the meaning of the decline which began in the market three weeks ago? Following the surge in the Dow from the 879.51 level of August 11, few are taking the decline seriously. It was expected, it was overdue, it was corrective. "One swallow does not make a Spring," and one decline hardly signals a bear market. In fact, in the face of the current monetary confusion people are almost pleased with the orderly decline of the past few weeks, for at least the market is acting logically—declining as it "should" when the news turns worrisome.

It appears to me that it will take well into January to see "what's coming off" on Wall Street. As this is written, tax selling is heavy, odd-lot selling (some of it seasonal) is heavy, and a dozen excuses can be advanced for anything that happens, be it a rise or a fall. By the second week in January the excuses will begin to die out, and the market action will be taken to be more meaningful.

My own guess is that 1000 on the Dow is not going to be seen in 1968—or 1969, either, for that matter. The second phase of the bear market has now lasted longer than any bear market second phase in history. The second phase so far has been concerned with upside action and speculation, but the Dow has nevertheless still failed to better the 1966 high of 995.15. My bet is that by the end of 1969 the old 995.15 mark will seem far, far away.

BIG PICTURE: As the new year looms, I want to include this long-term (yearly high-low) chart of the Dow since 1921. Particular attention is directed to the amazing rising channel which began at 92.92 on the Dow in 1942 and has carried to the present.



For twenty-five years, from 1942 to 1967 the Dow held within the confines of this longest upward trend in stock market history. Then, in 1968, a break appeared as the Dow dropped temporarily below the lower channel line (the 823.13 low of March, 1968). An immediate recovery ensued, and for the rest of 1968 the Dow again held within the limits of the rising channel.

For 1969 I estimate the lower channel limits to hold at about 950. In other words, it will be necessary for the Dow druing 1969 to hold above 950 if it respects the rising trend since 1942.

What would it mean if the Dow was to plunge below 950 during 1969? In my opinion, any decisive break below the lower 1969 channel line (below 950) would suggest a termination of the great rising trend of the past twenty-seven years. As a rule in stock market history, the longer a trend the more important that trend.

The only comparable technical trend in any market today is the long bear trend in bonds which began in 1946. It is entirely possible that the breaking of the rising trend in the Dow will correspond with the basing and ultimate reversing of the bear market in bonds.

It should be remembered that no trend continues indefinitely, or as William Hamilton stated, "No tree grows to the sky." Sooner or later, the current primary bear market in bonds must end. Already, bonds are providing the greatest bargain in fixed debt since the Civil War. At the same time, stocks are as speculative and overvalued as they have

been at any time in history. Some time during the next year I would expect the Dow to drop decisively below the rising channel, as the second phase of this bear market exerts its full force. And within a year or so from now, despite any monetary dislocations or panics which may develop, I would expect bonds to sink to rock bottom, thus providing the base for what could be a long-term (perhaps ten to twenty years) bull market in bonds again.

FIREWORKS: In all the time I have been in the investment business, I cannot remember a period when events moved so fast, when the news changed so rapidly, when so many variables bubbled in the pot.

From all quarters comes news of monetary troubles, statements on gold policy, denials, new controls, political changes. From my own standpoint, it is an exhausting period if for no other reason than that I must write my entire Letter nearer and nearer the deadline. What I write one day is very likely to be obsolete a day later. What I think on Monday regarding Nixon's gold stand may have to be altered that afternoon.

One thing seems to be clear. I have written all along that the forces of inflation throughout the Free World (and particularly the U.S.) have a rendezvous with deflation. It is clear to me that that rendez-vous is moving ever closer. When I wrote about the inflation-deflation confrontation a few years ago I was writing theoretically, the premise was difficult to see. Now, anyone who does not see it must be considered blind.

The temperature of the inflation-deflation battle can be measured with interest rates and the price of gold. I have tried in every way over the past few months to keep my subscribers abreast of what was happening in the money markets. I have repeatedly included charts of the Treasury bills, Treasury bonds, Municipal bonds, discount rates, prime rates, international bank rates.

On December 17 the Federal Reserve Board raised the discount rate from 5.50% to 5.75%. The next day the commercial banks raised their own prime rate from 6.50% to 6.75% (the prime rate is the rate the banks charge their leading or prime customers). This means that mortgage money (which runs about 1% above the prime rate) will move into the 7.75% category, an almost impossible level for most buyers.

It seems to me that the squeeze (money war if you like) is beginning. Furthermore, all this has occurred in the face of a giant rise in the U.S. money supply and a continuation in the booming economic activity and a continuation of rocketing inflation. What will happen if Nixon and his men keep their promise of balancing the budget and slowing down inflation? What would happen to interest rates and the economy if Nixon decided to contract the money supply? What will happen to the already collapsing bond market if Nixon decides that interest rates must go still higher in order to slow down the economy? As I have stated many times before, it is one thing putting the brakes on an auto going 30 M.P.H., quite another when the brakes are slammed on a car going 120 M.P.H. The U.S. economy is now going 120 M.P.H.

One signal for the money war has already flashed. Under Regulation Q the commercial banks can lend money under Certificates of Deposit (C/D's) as follows: 30 to 59 day C/D loans the top legal rate is 5.5% from the banks, on 60 to 89 C/D's the top rate is 5.75%, on 90 to 179 day loans the top rate is 6%, on 180 day and over C/D's the top rate is 6.25%. That is all very good. But note that the yield on the 91-day U.S. Treasury bills is now 5.94%. Why should a corporation or individual place money in bank C/D's for 91 days at the legal bank limit of 5.75% when he can get 5.94% from the Government on Treasury bills?

From leading bankers we now hear such statements as "The squeeze is on," or "We've been priced out of the market." As C/D money is pulled out of the banks and moved to other higher yielding instruments, bank credit is going to shrink. Banks will have their choice of borrowing more from the Federal Reserve or reducing their lending.

More interesting than the Reserve Board's belated raising of the discount rate on December 17 was their refusal to the rates for banks under Regulation Q. Frankly, I do not know what is going to occur next in this drama, but I note that my friend Irving Weiss (of Capital Advisors, 70 Wall St., N.Y.C.) states: "Why won't the Fed raise the ceilings on Regulation Q? Answer: It will throw the $200 billion in savings banks into a vulnerable position and probably start an interest rate war and throw doubts on the dollars standing." Then in a fascinating aside, Weiss shows that during each credit crunch since 1966 the C/D position at the banks grew more volatile. During the 1966 crunch, the average maturity of the $18 billion in C/D's outstanding was 3.6 months, 41% due in 60 days.

 During the 1967-68 gold-pound crisis the average maturity of the $21 billion in C/D's outstanding was 2.9 months, 51% due in 60 days. At the present time the average maturity of the $25 billion in C/D's outstanding is 3.2 months, 48% due in 60 days.

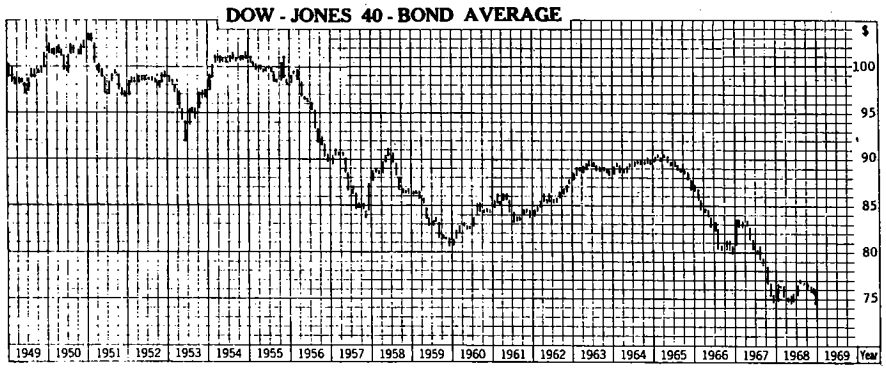
All of which means that our eyes should be focused on the 91-day Treasury bills. As they go over 6% in yield the competition for the bank's money is turning vicious. It is now Uncle Sam vs. the commercial banks, with the savings banks perspiring on the sidelines. Of course, the Savings and Loan institutions will also be sweating since they pay only up to 5.25% interest on deposits left for a specified length of time. To say that they do not want a rise in the regulation Q ceiling is an understatement. Already, the S & L's are priced out of the market for new money, and if the trend continues the S & L's should be subject to large withdrawals.

* * * *

Most of the foregoing is a discussion of domestic monetary problems. But it should be noted that Canada raised her bank rate from 6% to 6.5% last week. At the same time Belgium raised her rate from 3.75% to 4.5%, as did Holland. Many other nations with monetary problems can be expected to raise their bank as a protective measure. There will be sharp bidding for Eurodollars (American dollars in Europe) since these foreign deposits are subject to no rate ceilings.

In almost every major industrial nation in the Free World, the battle against inflation and monetary chaos is occurring. In every nation, the confrontation between inflation and deflation is out in full view. More inflation means shaky currencies and adverse trade balances, deflation means unemployment, labor agitation, loss of votes.

Meanwhile, the world seems to be waiting for President-elect Nixon to take over and for the new Administration to announce its policies. But crises have a habit of refusing to wait for the time when they "are allowed to happen." I wonder if everything is going to bubble along merrily until Mr. Nixon can formulate his plans.



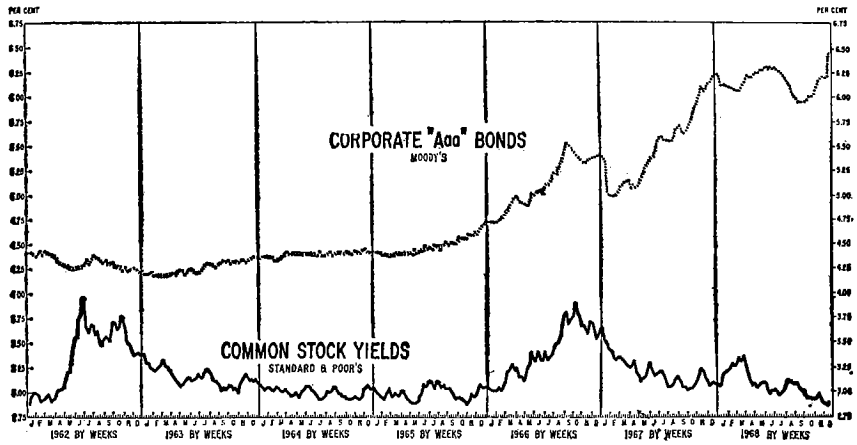
UP AND UP: Thursday, December 19, was an historic day in money market history. On that day the U.S. Treasury 91-day bills moved over the 6% yield level for the first time in history. On the same day the bellwether of the Treasury long-term bond market, the 4¼'s of 1987-92 sank sharply to historic lows of 77 13/64's bid. Having come out on August 15, 1962 at a price of 97, these Government bonds have now lost almost a quarter of the value. At last week's record low, the highest quality bonds yielded a record 6.04%.

Last week the broad D-J 40 Bond Average dropped to 74.15, lowest price since the Depression year 1933 (see chart). At that price the D-J 40-Bond Average yielded an amazing 6.88%, a full 3.61% more than the yield afforded by the D-J Industrials.

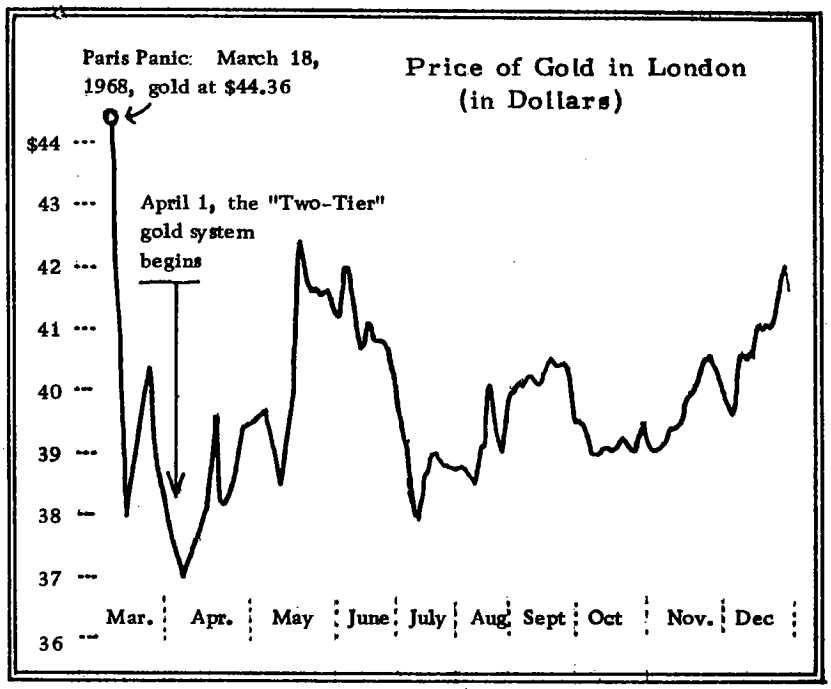
But the most astounding and bearish statistic of all was last week's adverse spread between Moody's Aaa-rated bond yields and the S & P 500 stock average. Moody's Aaa bonds pushed to a record high yield of 6.44%. At the same time, the yield on the S & P 500 stocks stood at 2.90%. The S & P 500 yield has thus held below the critical 3% yield level for 13 consecutive weeks (the historical average has been six weeks before trouble begins).

The adverse yield gap between the Aaa bonds and the S & P 500 stocks advanced to 3.54% in favor of bonds, the greatest adverse spread in history (see chart, page 5). Never has the strain between stock and bond yields been so flagrant. Nothing can justify such a spread except an abiding faith in inflation and rising corporate earnings against a background

of pessimism for the bond market. I personally doubt that such conditions will last much longer, particularly in view of the anti-inflation sentiments of the Nixon assemblage.



GOLD: I have been saying that no Nixon or Nixon cabinet statements have been released on the price of gold. On December 17 Treasury Secretary-designate David Kennedy broke the silence with a surprising statement. When asked about the price of gold Mr. Kennedy astounded the world with his honesty. "I want to keep every option open that the new Administration should have." He said further, "I have no fixed position" on gold. In defending his refusal to commit himself on $35 gold, Mr. Kennedy stated, "I have to live with my words."



The price of gold had been heading up prior to Kennedy's remarks (see chart). On word of the Kennedy statement, gold in London jumped to $42 per ounce. Next day as international gold markets roared, Mr. Nixon must have seen fit to soft-pedal the Kennedy statement. Nixon's press aid, Ron Ziegler told newsmen that the Nixon Administration did "not anticipate any change in the price of gold." I thought it was a luke warm statement, which nevertheless left all the doors open. I noted also that the announcement did not come from Mr. Nixon personally.

It occurs to me that Nixon will have to deal with the monetary crisis quickly after assuming office. If he waits as much as six months, it will not be LBJ's mess any longer, it will be Nixon's. Secondly, if there is to be a crisis I would guess that Nixon would rather have it come between now and the time Nixon takes office—rather than after. It's a simple matter of human nature. Nixon knows what is going on, he knows it is not his doing, why should he be anxious to have the whole affair thrown full-brunt in his lap a month or so after he takes office?

NOTES & QUOTES: From the latest London Economist "A CABINET OF NIXIONS: Mr. Nixon has chosen to surround himself with men very like himself—which is no surprise, but isn't very encouraging either."

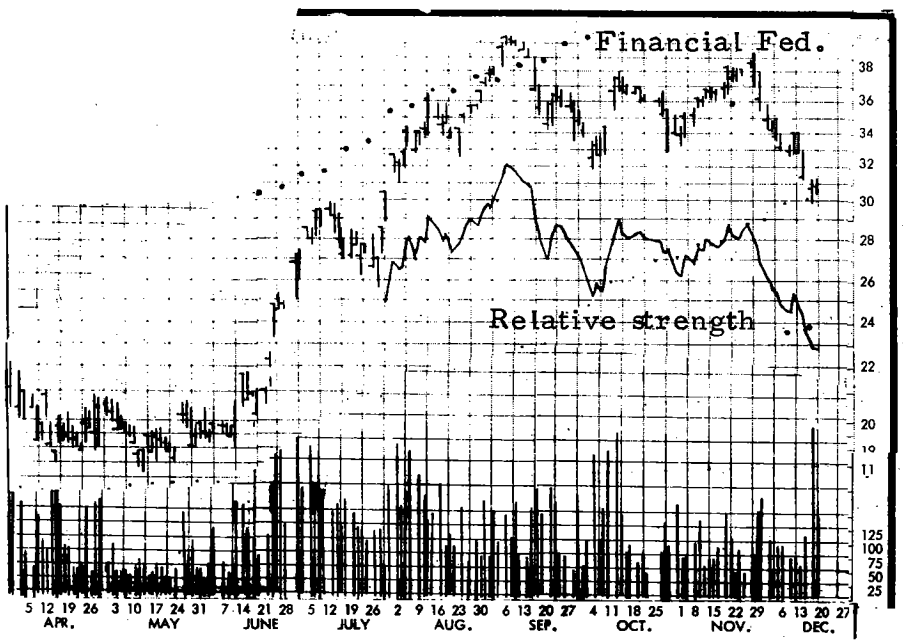
From "contrarian" Humphrey Neill's Dec. 18 report: "I have been in contact with Wall Street for 40 years—have written a Stock-Exchange history and other books—and I cannot recall any stock-market period that compares with the present era. It is unbelievable, what's going on. If anyone had predicted we would see the rampaging markets we've been having he would have been laid out on the couch for analysis. It's true that this writer has worn the speculative theme thin with repetition, but I did not visualize the extent to which speculation would surge.

"And the multiplicity of funds! Good grief, is there no end to them? I don't pick up a Journal or Chronicle that I don't see a new one announced—and what language: 'A fund for rapid growth, taking risks to accomplish it,' or words to that effect. Or—'A new fund for superior performance,' for instance. The get-rich-quick savor comes through (as do advertisements about winners just dug up)."

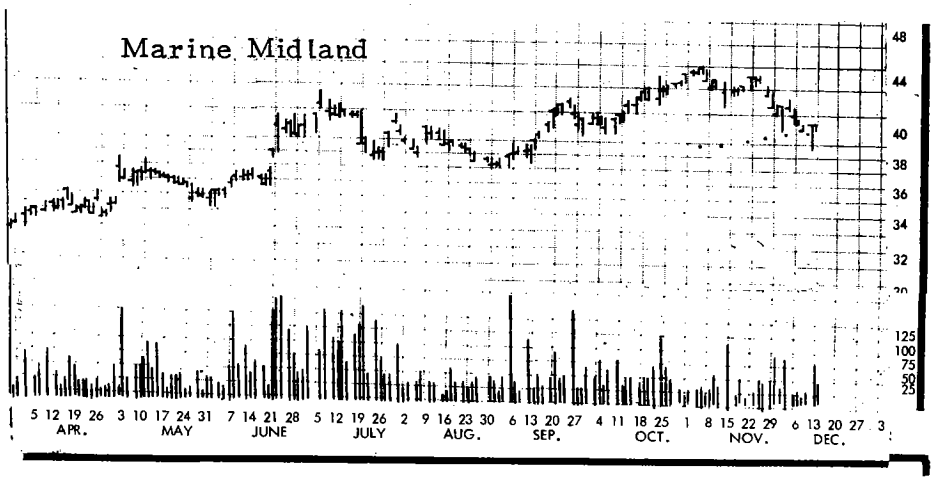
From the Dec. 18 Janeway Service: "To Crunch Or Not To Crunch is rapidly ceasing to be the big question it has been advertised as being. Under cover of the debate about whether a new credit crunch may be in the making, a new credit crunch has been arriving. Its carrier has been the Treasury bill rate, which has pushed through to a premium above the effective CD rate; and its arrival is all the more ominous in its timing because the boomerang-loaded surtax of 1968 and the promised spending cutbacks with which it was packaged invited expectations of a lower bill rate at this point in time."

From the January Alden R. Wells Monetary Report: "Any crisis— domestic or foreign— has in recent years been used as a reason to escape from paper money into stocks. The financial community, with few exceptions, uses this as its current theme song. Originally the theme was 'buy a share in America,' from this it changed to 'Buy Growth,' and now 'Escape from Paper.' When this sales effort is finished and everyone has escaped from paper to equities, we assume the next theme will be 'Have confidence in America' accompanied by urgings to hold onto your stocks. Why people who have been told that they should have no confidence in the nation's paper should acquire confidence when it is being liquidated is a mystery the financial community has never yet been able to solve."

MARKET LABORATORY: One of the first groups to react to the money crunch, was of course, the money stocks. I have pictured two of them on this page. Financial Federation (FFI) is a large Savings and Loan holding Co. and here we see the double top in the 40 area, followed by the sharp break of the past few weeks which has taken FFI down to 30. The decline has wiped out all gains since July.



Marine Midland, a large bank stock, has rolled over from the October high of 46. Last week Marine touched 40, while breaking its September lows. My guess would be that both of the "money" stocks have topped out, and it should be remembered that the money stocks led the way down during or just before most of the other "money crunches" of the past two years.



Significantly, I might add, General Motors, which depends heavily on credit to finance its car sales, has backed off from its October high in the 90 area. Relative strength on GM last week touched a low for 1968. Charts courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62002.

May I take this space to wish all my subscribers a happy and prosperous New Year.